

No. 10,373

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

MOHAWK PETROLEUM COMPANY (a California corporation), EDWIN V. MCKENZIE, as Executor of the Estate of Alfred L. Marsten, Deceased, EDWIN V. MCKENZIE, ALFRED L. MARSTEN, JR., and LEWIS A. MARSTEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Upon Petition to Review Decisions of the Tax Court
of the United States.

OPENING BRIEF OF PETITIONERS.

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FOREWORD.

Annual depreciation on "wells equipment" was based by taxpayer on a "unit of production" method whereby the tax rate per barrel of oil produced was determined for each lease by dividing the capitalized cost of physical equipment (less salvage) by the estimated future production of the entire lease.

Under such method the amount of depreciation on each well and its equipment was determinable at all times. Four

wells were abandoned. Deduction for loss thereon was denied by the Commissioner on the ground that where an average depreciation on a group of items is taken **“based upon the average lives of such assets”** losses are not allowable because an average rate contemplates a normal retirement both before and after the average life is reached.

Petitioner asserts that the composite rate is not based upon the average life of physical assets but on the economic life of the oil lease. It presupposes that all of the equipment will last the life of, and that none of the assets could have a useful life longer than, the oil lease.

“Thus the depreciation there, and the deductions being calculated upon the maximum economic life of the entire plant, not the average life of separate assets, the loss deductions were proper.”

U. S. Ind. Alcohol Case (42 B.T.A. 1377-8, reviewing the Illinois Pipeline Case).

The sole reason of the rule adopted by the Commissioner is to prevent double recoupment by the taxpayer (1) by depreciation; and (2) by abandonment loss. No such result being possible under the method used by taxpayer, the application of the rule ceases with the absence of the reason therefor.

A. THE PARTIES.

This is a petition for the review by this Honorable Court of the decision by the United States Board of Tax Appeals rendered on November 4, 1942, reported in 47

B.T.A. 130 in the above entitled consolidated proceedings. (Tr. p. 67.)

Mohawk Petroleum Company is a California corporation with its principal office in San Francisco; reference will be made to it herein as "petitioner" because all other petitioners received its assets in liquidation as stockholders, and are liable as transferees for its tax deficiencies. Tax returns for periods involved were filed with the Collector of Internal Revenue for the First District of California. All petitioners are residents and inhabitants of the same district. (Tr. pp. 91-92.)

B. PETITIONER ABANDONED FOUR OIL WELLS.

Involved is the determination of liability of Petitioner for Federal income and undistributed profit taxes for 1936 and 1937 (fiscal year base). In those years Petitioner abandoned four oil wells situated on three separate leases in Kern County, California. In each instance other oil wells on the same lease continued to produce oil.

Since organization, Petitioner has consistently charged to expense intangible drilling cost; and, has capitalized separately the "well equipment" (casing, tubing, etc.) of each well. The abandoned wells were so capitalized.

On abandonment Petitioner deducted the cost of the well equipment, less salvage and prior depreciation, as a loss. By deficiency notice, the Commissioner disallowed same. These losses were: 1936, \$5,044.13; 1937, \$35,026.52. The tax deficiencies computed thereon were \$991.84 and \$15,603.44, respectively. Of those taxed sums, approxi-

mately \$900.00 and \$9,000.00 are referable to the issue here raised. (Tr. p. 93.) A most elaborate calculation is required to determine the precise amounts due to the necessity of adjusting allowable depletion which is contingent upon depreciation allowable and which is in turn contingent upon whether the abandonment losses herein contended for are allowable.

C. COMMISSIONER'S GROUND FOR THE DISALLOWANCE OF THE LOSS.

“Since your tangible well equipment installations on each leasehold in question consist of more than one installation and depreciation has been based upon the average lives of all of such installations, losses claimed on normal retirements of such assets are not allowable inasmuch as an average rate contemplates a normal retirement of assets both before and after the average life has been reached, and there is therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired or disposed of”. (Tr. p. 18.)

D. THE REGULATION UNDER WHICH THE COMMISSIONER ACTED.

Article 23 (e)-3 of the Respondent's Regulations 94 with respect to the Revenue Act of 1936 contains the following paragraphs:

“If the depreciable assets of a taxpayer consist of more than one item and depreciation whether in respect of items or groups of items, *is based upon the average lives of such assets*, losses claimed on the

normal retirement of such assets are not allowable inasmuch as the use of an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired. In order to account properly for such retirement the entire cost or other basis of assets retired, adjusted for salvage will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered”.

“In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the loss of the asset (adjusted as provided in section 113(b) and articles 113(2)(14)-1, 113(b)-1, and 113(b)-2 less its salvage value is allowable upon its retirement. (See articles 23(1)-1 to 23(1)-10.)” (Italics supplied.)

This regulation was formerly referred to as MIM. No. 4170.

The Treasury maintains that if taxpayers use depreciation rates based upon the average lives of depreciable assets instead of maximum lives, under the said regulations, losses on retirement are disallowable. Such disallowed losses are chargeable to the depreciation reserve. It maintains that the allowance of losses on retirement, in addition to the allowance of depreciation at the average rate, would result in the recovery by the taxpayer of all of

its investment by the end of the average life while still deriving the benefits from use of the substantial quantity of fully depreciated plant assets that possess a useful life beyond the average life. The facts in each case should govern.

A taxpayer using a composite or average rate should be allowed a loss if a change of conditions necessitates replacing any asset which had been in use for the period upon which the composite rate was in part based. To require that the loss be charged to the reserve would be to defer a deduction beyond the date of actual loss and the Treasury clearly intended, under the Regulation, to allow such a loss immediately.

E. PRIOR CASES WHERE THIS REGULATION HAS BEEN CONSTRUED AND THE COMMISSIONER'S RULINGS THEREUNDER HAVE BEEN REJECTED.

Illinois Pipeline Co., 37 B.T.A. 1070 (June 21, 1938);

U. S. Industrial Alcohol Co., 42 B.T.A. 1323 (November 28, 1940);

Mason City Brick and Tile Co. v. Huston (D. C.),
36 Fed. Supp. 515 (January 3, 1941).

(Referred to herein as *Pipeline*, *Alcohol* and *Brick* cases.)

**F. THE GENERAL RULE IS THAT LOSSES DUE TO
ABANDONMENTS ARE ALLOWABLE.**

Revenue Act of 1936, Article 23 (E)-1—Loss by Individuals.

“Losses sustained by individual citizens or residents of the United States, and not compensated for by insurance or otherwise, are fully deductible if (a) incurred in the taxpayer’s trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck or other casualty, or theft, and a deduction therefor has not, prior to the filing of the return, been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Act. * * * Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See Section 113-B.”

Article 23 (F)-1—Losses by Corporation.

“Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited by Sections 23G-24A-6-112-117-118 and 251. The provisions of Articles 23(e)-1, 23(e)-2, 23(e)-3, 23(e)-4, 23(e)-5, and 23(h)-1 are in general applicable to corporations as well as individuals.”

**G. THE “UNIT OF PRODUCTION” METHOD OF DEPRECIATION
USED BY THE PETITIONER.**

Since its organization the Petitioner has consistently depreciated the tangible well equipment connected with the several wells on each lease on the “unit of production”

method, the method being applied in such manner that the amount of depreciation taken with each well (as distinguished from each lease) was determinable. Because the issues here are dependent on application of definite legal principles applicable to this method, we believe it necessary to amplify the mere abstract statement.

The amount in dollars of the annual depreciation was computed by multiplying two factors (a) the rate per barrel of oil produced during the year; and (b) the base, being the amount against which the rate was applicable.

The rate: a depreciation rate per barrel of oil produced was determined for each lease by dividing (1) the capitalized cost of physical "well equipment" (less salvage allowance) by (2) the estimated future production (oil reserves) of the entire lease.

By example:

| | <u>Cost</u> | <u>Salvage</u> | <u>Net Base</u> |
|---------|-------------|----------------|-----------------|
| Well #1 | 10,000 | 10% | 9,000 |
| Well #2 | 15,000 | 10% | 13,500 |
| Well #3 | 20,000 | 10% | 18,000 |
| | <hr/> | | <hr/> |
| Total | 45,000 | | 40,500 |

Estimated future production of lease in barrels of oil (oil reserves) 1,620,000 barrels. Therefore, $\$40,500 \div 1,620,000$ equals 2.5 cents per barrel, which is the rate.

The resultant rate per barrel was then multiplied by the barrels of oil produced each year by all wells on the lease to determine the depreciation for the year. If it be assumed that the actual production on the lease was as follows:

| | |
|---------|----------------|
| Well #1 | 20,000 barrels |
| “ #2 | 20,000 “ |
| “ #3 | 41,000 “ |
| <hr/> | |
| Total | 81,000 “ |

Then the amount of depreciation to be charged would be: 81,000 (the base) by 2.5 cents (the rate) equals \$2,025.00.

Being a control account, Petitioner's books carried one depreciation reserve account for the equipment upon each lease but necessarily such account was built up by applying the depreciation rate per barrel to the production of each well; it is perfectly clear, therefore, that the figures reflected were a mere aggregate of those obtained by using the rate against the production of each well to obtain the amount of money to be charged against the depreciation reserve.

We emphasize this very important fact!

Consequently, the part of the reserve that was applicable to the abandoned well equipment was readily computable at any time on the basis of book entries, that is, known factors (the production of each well and the depreciation rate during each year).

By example:

| | |
|-------------------|----------------------------|
| Year 1934—Well #1 | 200,000 barrels |
| “ #2 | 300,000 “ |
| “ #3 | 100,000 “ |
| <hr/> | |
| | 600,000 @ 2.5¢ \$15,000.00 |
| Year 1935—Well #1 | 100,000 barrels |
| “ #2 | 200,000 “ |
| “ #3 | 20,000 “ |
| <hr/> | |
| | 320,000 @ 2.5¢ 8,000.00 |

| | |
|--|-------------|
| Reserve account balance, for first two | |
| years of production | \$23,000.00 |

If Well No. 3 is abandoned during 1935 it is obvious that the part of the \$23,000.00 balance that is applicable to its equipment is \$3000.00. If either of the other wells were abandoned during that year the respective amounts applicable would be Well No. 1, \$7500.00, and Well No. 2, \$12,500.00.

A new depreciation rate was computed whenever additional wells or additional capital items were added to existing wells during a year, or when it became appropriate, because of production experience, to increase or decrease the estimate of the remaining recoverable barrels of oil from a particular lease. When a well was abandoned the loss was determined and written off, such loss being measured by the excess of (1) the cost of the related physical equipment reduced by the salvage, if any, over (2) the prior depreciation which had been accounted in respect of such equipment.

It is concluded therefrom:

(1) That it was immaterial whether depreciation was computed (1) by multiplying the production of each well and aggregating the depreciation thus computed as to each well, or (2) by multiplying the aggregate production of all wells on a particular lease by the rate.

(2) That identically the same total of depreciation results from either method.

(3) That the part of the total depreciation developed by the second method (used by Petitioner) which is applicable to each well is determinable at any time by simple arithmetical process with the same accuracy as if the first method had been followed.

(4) That under the "unit of production" method as applied by Petitioner the amount of depreciation on each well and its equipment was determinable at all times.

H. PETITIONER'S CONTENTIONS.

The errors relied upon for reversal are those set forth in paragraphs 1 to 12 in assignments of error in the petition. (Tr. pp. 98 to 101.)

That there are two distinct classes of average or composite depreciation cases:

A. Where the composite rate is based on the average and varying physical lives of several articles (Alcohol case), and

B. Where the composite rate is based on the economic life of a group of articles as measured by something other than the physical lives of the several articles of the group, as here, by the production in barrels of oil from a particular field or lease (Pipeline case).

The "A" cases are divided into two classifications:

1. Where one or more of the articles comprising the average live a "normal" life yet less than the average no deduction for abandonment or retirement will be allowed because it would result in a double repayment to the taxpayer, (1) by depreciation, and (2) by abandonment loss. The lesser life of such an article has already been allowed by bringing a longer lived article down to the average; and

2. Where one (or more) of the articles (comprising the average) live less than its "normal" life as computed in arriving at the average, a deduction for loss by abandonment or retirement will be allowed of the capitalized cost, less salvage and prior depreciation.

The "B" cases have two classifications:

1. Where the economic life of an oil field is estimated in years (20) and a straight line depreciation (5%) is used a loss upon abandonment or retirement is allowable (Pipeline case); and

2. Where the economic life of an oil field is estimated by the number of barrels of oil it will produce, which estimate is adjusted by actual production so that depreciation extends until the last barrel of oil is actually produced, and the owner thereof obtains by way of depreciation and/or abandonment or retirement loss the precise amount of his capital investment in the physical equipment used to produce the oil, a loss upon abandonment or retirement is allowable (Mohawk case).

Petitioner concludes:

That the facts bring this case within "B-2"; that "B-2" and "B-1" are identical in principle.

That even if it be determined that the case is within "A" group it is within "A-2" and not within "A-1".

That to allow the loss cannot possibly result in a "double" return to the taxpayer.

That to deny the loss prevents the taxpayer from obtaining same when it occurs.

I. AN ANALYSIS OF THE AVERAGE METHOD OF DEPRECIATION APPLIED TO VARYING PHYSICAL LIVES OF SEVERAL ARTICLES.

U. S. Industrial Alcohol Company v. Commissioner,
42 B.T.A. 1323 (Nov. 28, 1940).

“A composite rate may be arrived at by taking average depreciation based upon the anticipated life of the assets concerned, weighted for their respective costs. The resulting rate is then applied to the entire group of assets involved.” (p. 1375.)

By example (A):

| Article | Cost | Life | Dollar Life | Average life per Dollar-Cost | Annual rate of Depreciation |
|---------|--------------|------------|--------------|------------------------------------|--------------------------------|
| A | \$600. | x 8 yrs. = | \$4,800. | | |
| B | 400. | x 3 yrs. = | 1,200. | | |
| | <hr/> 1,000. | | <hr/> 6,000. | 6 years | 16 $\frac{2}{3}$ % |

(table supplied by Petitioner)

“* * * Under this theory of a composite rate, it is proper to eliminate from the base the cost of assets as they arrive at the end of their useful lives. This results from the fact that the composite rate is an average and that some assets will actually have a shorter and some a longer period of existence than the useful life appropriate to the average.” (Thus B article is shorter and A article is longer than the average life of six years.) “Only if the base is constantly reduced by the cost of the assets removed from it as they reach the end of their anticipated useful life will it be possible for the owner to continue to take depreciation deductions beyond the median point and while some of the longer lived assets are still necessarily employed.” (pp. 1375-6.)

In the above weighted average example, it is apparent that all the assets would be fully depreciated at the end of the sixth year and there would be nothing left against which to charge depreciation for the seventh and eighth years. An essential prerequisite to the proper operation of the composite method is the principle of a diminishing base against which depreciation is both charged and computed. Assume article "A" has lived precisely eight and article "B" three years.

By example (B):

| | Article | Cost | Rate | Amount of Depreciation |
|------------------|---------|----------|--------------------|------------------------|
| 1st year | A+B | \$1,000. | 16 $\frac{2}{3}$ % | \$166.67 |
| 2nd year | A+B | 1,000. | 16 $\frac{2}{3}$ % | 166.67 |
| 3rd year | A+B | 1,000. | 16 $\frac{2}{3}$ % | 166.66 |
| 4th year | A | 600. | 16 $\frac{2}{3}$ % | 100.00 |
| 5th to 8th years | A | 4 x 600. | 16 $\frac{2}{3}$ % | 4 x 100.00 |

1,000.00 returned by
depreciation

(table supplied by Petitioner)

The base has been reduced at the end of the third year by the entire cost of "B" even though no deduction for retirement has been taken because its lesser life has been compensated by bringing the eight year life article to the average of six years. To allow a loss for its retirement in three years would operate to give a double deduction for (1) depreciation and (2) retirement. If, however, it be assumed that article "B" is retired at the end of one year the base must *then* be reduced by its cost.

By example (C):

| | Article | Cost | Rate | Amount of Depreciation |
|--|---------|----------|--------------------|--|
| 1st year | A+B | \$1,000. | 16 $\frac{2}{3}$ % | \$166.67 |
| 2nd year | A | 600. | 16 $\frac{2}{3}$ % | 100.00 |
| 3rd to 8th years | A | 600. | 16 $\frac{2}{3}$ % | 6 x 100.00 |
| | | | | <hr/> |
| | | | | 866.667 returned by depreciation |
| (Cost \$400—depreciation \$266.67)= used in computing average of six years. | | | | 133.333 returned by retirement allowance |
| | | | | <hr/> |
| | | | | \$1,000.000 |
| (table supplied by Petitioner) | | | | |

A disallowance of the retirement loss would prevent taxpayer obtaining its cost within the eight year period.

This principle is applied in the opinion to a non-weighted average:

“A simple illustration will suffice. Assume five assets, each of the same cost basis, having anticipated useful lives of one through five years. The average life will be three years. On the theory that this calls for a depreciation rate of 33 $\frac{1}{3}$ %, that is also the weighted average since the costs are identical. Depreciation taken on the full original cost basis would exhaust the total investment at the end of three years and no depreciation would be allowable after that time, even though some of the assets would, by hypothesis, remain in use during the fourth and fifth years. Thus, for almost half the time, the taxpayer would be deprived of an annual deduction for depreciation” (p. 1376) (and his net income account distorted). See example D, *infra*. “If, however, the cost basis is reduced each year as one of the assets is removed from the group by

reason of normal retirement, and, assuming no replacements, the gradually diminishing base and hence the reduced amount of depreciation, will enable the taxpayer to continue to depreciate the assets remaining in each year at the composite rate throughout the fifth year and the result will be an exact recovery at that time of the original cost of all the assets. It follows that, if an asset forming part of a group subject to a composite depreciation rate is retired because it has reached the end of its normal life, only its elimination as the cause of additional deductions will avoid unnecessarily premature depreciation on the one hand or double deduction on the other." (p. 1376.) See example E, *infra*.

"The principle to be applied to a composite rate in such a case as this, therefore, is that assets which are retired at the end of their normal life cannot be permitted to furnish further compensation by way of a deduction for loss on retirement, even though they may be retired in advance of the entire group. Their early retirement will be compensated for by depreciation taken after the average period has passed."

Assume five articles with respective lives of 1 to 5 years. To determine between two methods of computation and to show the difference in *yearly* depreciation between them (although both result in a full return of the capital of \$50.) we make the comparison:

| <u>Example E</u> | | <u>Example N</u> | |
|-----------------------------|-----------------------------------|--------------------------------------|-----------------------------------|
| Composite or Average Method | | Straight Line Separately Computed | |
| | <u>Amount of Depreciation</u> | | <u>Amount of Depreciation</u> |
| 1st year..... | \$16.67 | | \$22.8333 |
| 2nd " | 13.33 | | 12.8333 |
| 3rd " | 10.00 | | 7.8333 |
| 4th " | 6.67 | | 4.5000 |
| 5th " | 3.33 | | 2.000 |
| Total..... | \$50.00 | | \$50.00 |

Example N having served the purpose of illustration, is no longer significant here: it has served to make clear the statements in the Alcohol decision, and is foundational to the next and more important distinction.

We now compare Examples E and D.

| <u>Example E</u> | | | <u>Example D</u> | | | |
|---|------|--------------|------------------|--------------|---------------------------|--------------|
| Capital | Rate | Amt. of Dep. | Cost | Bal. of Cost | Rate | Amt. of Dep. |
| 1st year.....\$50.00 x 33 $\frac{1}{3}$ % | | \$16.67 | \$50.00 | \$50.00 | \$50 x 33 $\frac{1}{3}$ % | \$16.666 |
| 2nd " 40.00 x 33 $\frac{1}{3}$ % | | 13.33 | 50.00 | 33.33 | 50 x 33 $\frac{1}{3}$ % | 16.666 |
| 3rd " 30.00 x 33 $\frac{1}{3}$ % | | 10.00 | 50.00 | 16.67 | 50 x 33 $\frac{1}{3}$ % | 16.666 |
| 4th " 20.00 x 33 $\frac{1}{3}$ % | | 6.67 | | | | |
| 5th " 10.00 x 33 $\frac{1}{3}$ % | | 3.33 | | | | |
| Total\$50.00 lost | | \$50.00 | \$50.00 lost | | | \$50.00 |
| | | gained | | | | gained |

Query: What is the average or composite method? Is it as reflected in Example "E" or Example "D"? The difference in yearly return is patent enough. But upon what principle is the difference predicated. We lay great stress upon the proposition.

The composite method is not an average rate over the average lives of the several articles; it is an average rate over the whole period measured by the life of the longest lived of the several articles.

It will be noted that the main factual difference is in the circumstance that in "D" all depreciation stops at the end of the third year and while articles 4 and 5 still have remaining lives of 1 and 2 years, whereas in "E" the base constantly diminishes as each of the five articles "lose their lives". Nevertheless the rate itself is the same as in "D"; it is an average and composite rate although applied to a diminishing base. The base diminishes, not in accordance with the amount of money charged as depreciation but because articles have been taken out of the base because the lives of such articles have expired causing retirement or abandonment. The Commissioner asserts a certain regulation is applicable; applying the controlling sentence thereof to the 1st and 2nd year articles of the example: "Their early retirement will be compensated by depreciation taken *after* the average period (3 years in the example) has passed". It conclusively follows that the regulation means Example "E" and not Example "D" because in "D" there is no depreciation taken after the average period. From this follows indubitably that wherever a composite or average method of depreciation is used, it means a constantly decreasing amount returnable "on the expected life of the longest lived asset contained in the account". The quoted language is from the same regulation relied on by the Commissioner and provides that under such circumstances, a deduction, less salvage, is allowable upon retirement.

We continue the quotation:

“What has been said, however, applies only to normal retirements; and the converse of the statement is also true. If assets are removed from the group as a result of abnormal retirements resulting from unanticipated causes occurring before the end of the normal life attributed to such assets in arriving at the composite rate, the resulting loss is the proper ground for a deduction. Such losses are not to be compensated for by way of depreciation, *Southland Coal Co.*, 16 B.T.A. 50, and if not permitted as deductions will prevent the final recovery of the entire original cost.” (pp. 1378-1379.)

Two important circumstances are noted in the above quotations; they have reference to (1) a true composite rate, and (2) varying physical lives of the several articles. Even under such circumstances, premature abandonments are allowable as deductions.

J. WHERE AVERAGE RATE WAS BASED ON ECONOMIC LIFE OF AN OIL FIELD, ABANDONMENT LOSS WAS ALLOWED.

All that has been hereinabove set forth was deemed by us necessary to an understanding of the general principles underlying all composite rate cases. We have been dealing with the subject of depreciation where the rate is fixed in reference to a particular standard, to wit: the varying physical lives of the several articles depreciated. We come now to that class of case where rates are computed on a standard other than varying physical lives of the several articles and where as a group a number of articles are de-

preciated against a wholly different standard—their utilitarian life in connection with a natural resource. The life of the resource and not the life of the equipment becomes the measure of the rate of depreciation. Such resource *itself* diminishes; it is a wasting asset in that as it is extracted the producible amount left represents not only the balance thereof but the remaining economic life of the equipment necessary to produce it.

In this classification there are two distinct methods of computation as exemplified in the *Pipeline* and the *Mohawk* cases. In both the same natural resource, oil, was the basis of dispute. In the *Pipeline* case depreciation was computed on an assumed life of two oil fields determined solely by the estimate of twenty years. It was never adjusted. The rate of depreciation was a flat 5 per cent. If that mode of determination is in legal effect the same as that used by Petitioner then it conclusively follows that the holding of the Board there ought to have been applied here. We proceed to show that the only difference between the two cases exists in favor of the *Mohawk* case, that even stronger reasons here exist for the invocation of the rule there applied.

Illinois Pipe Line Co. v. Commissioner, 37 B.T.A.
1070 (June 21, 1938):

The facts. The taxpayer was organized to take over the pipe line system of the Ohio Oil Company and to operate same as a common carrier. This pipe-line system consisted of main trunk pipe lines, feeder lines and gathering lines; pumping stations, and pumping buildings, tankage, etc. By the term “gathering lines” is meant smaller lines within an oil field to transport oil to a common point.

The system served several oil producing areas. Depreciation had been computed on all the depreciable assets by the taxpayer (and its predecessor) at an annual rate of 5% upon the theory that they had an economic life of twenty years dated from July 1, 1915, because the oil fields served had a probable economic life of twenty years dated from July 1, 1915, though the physical depreciation during the time it was operated by the predecessor was but 1% per annum.

Certain parts and sections of the line system were retired because the amount of oil produced in one field was so small that the line could not be profitably operated; one part of one of several parallel lines was sold and thereafter used by purchaser to transport natural gas. Another section was abandoned because the proration of oil production lowered the amount of oil carried in that line. There were other discards and abandonments of "laid pipe".

On retirement of general asset items the difference between cost and accrued depreciation, less salvage value, was written off (by being charged to retirement loss account). There was a difference in accounting for laid pipe. Investments on these items were kept according to the size of the pipe, as, for instance, the 8 inch was in one account, regardless of whether it was part of the original investment or subsequently purchased. When a section of such pipe was retired the amount credited to the investment account (and written off by being charged to retirement loss account) was computed by multiplying the number of feet of pipe retired by the average cost per foot of 8 inch pipe carried in the investment account on the date of the retirement. The amount so credited was diminished by a

percentage which was equivalent to the ratio of the total accrued depreciation in the depreciation reserve for 8 inch pipe to the total investment in 8 inch pipe and the balance, less salvage value, was charged to the retirement loss account. A similar procedure was followed in making adjustments to the "Pipe Line Construction" account for 8 inch pipe, the capital account which reflected the construction cost of the pipe lines retired.

"In its income returns for the years under review (1929 and part of 1930) the petitioner claimed retirement losses, computed in the foregoing manner, as deductions from gross income".

The amount involved on this issue (for both periods) was \$316,521.60. The deductions for abandonment and retirement losses were allowed in full by the Board.

The reasoning in the opinion for the determination is hereafter set forth in a quotation from the *Alcohol* case where a distinction is drawn between the two classes of cases.

This brings us to the difference in the facts in the *Alcohol Co.* and the *Pipeline Co.* cases. This clear distinction is drawn by the Board in the *Alcohol Co.* case. We quote:

"Even stronger reasons require that there be no excessive compensation by permitting loss deductions upon normal retirements. Since the composite rate assumes that some assets will be retired before, and some after the average, those reaching the end of their *expected* life, whether before or after the average, do not result in any loss. And to permit any to be taken would tend to cause double deduction even more certainly than would the failure to reduce the base. The

following statement in *Illinois Pipeline Co.*, supra, may at first glance appear to indicate the contrary: 'However, if the basis is reduced as assets are retired, the entire cost of the retired assets cannot be recovered unless the depreciated cost of the retired assets is allowed as a deduction at the time of their retirement'. *This statement was undoubtedly correct as applied to the facts in that case.* The 5 per cent rate used there was arrived at by assuming a 20 year life for all of the assets. It was the result of an anticipated destruction at the end of twenty years of the oil fields which were being served by the pipeline. It is evident that none of the assets under those circumstances could have had a useful economic life longer than 20 years, and, since the rate adopted was 5 per cent, assets having a shorter life than 20 years would be retired at a loss. Thus the depreciation there, and the deductions, *being calculated upon the maximum economic life of the entire plant*, not the average life of separate assets, the loss deductions were proper. * * * The statement quoted therefore, while expressing the rule applying to the facts in that case, is not to be considered as applicable to a case where a composite rate is arrived at by averaging rates appropriate to anticipated lives of varying lengths". (pp. 1377-8.)

"It is evident that none of the assets under those circumstances could have a useful life longer than 20 years, and, since the rate adopted was 5 per cent, assets having a shorter life than 20 years would be retired at a loss."

What is the precise meaning of this statement. Does something have to be added to apply it to the facts of the *Pipeline* case? To the end of the sentence should be added a phrase to express that which it necessarily

implies: The implied phrase is: "unless such 'shorter life' articles are permitted to remain in the account after retirement". It is evident that so remaining the entire value including that of the retired articles would be repaid at a 5% rate in twenty years. From this it follows that such articles must be retired from the base at the time of retirement. So construed (it seems the only reasonable construction) the same sentence is transposable to the facts of the instant case.

It is evident that none of the assets under those circumstances could have had a useful life longer than the life of the last barrel of oil produced, and since the rate adopted was computed by a ratio of remaining unproduced oil to the cost of equipment depreciated, such part of the assets having a shorter life than measured by the last barrel of oil produced would be retired at a loss "unless such shorter life articles are permitted to remain in the account after retirement".

K. A COMPARISON OF PIPELINE AND MOHAWK CASES.

Just as the quoted case, in the instant one, the depreciation is "keyed" to the production of the oil, not in fixed years but the actual life thereof, economic life of all articles rather than varying physical lives. We review the method used by petitioner: Assume 6 wells, each with a capitalized cost for well equipment of \$10,000.00. Salvage value is immediately deducted to obtain the net capitalized cost against which depreciation is chargeable. Oil reserves (future production) is 2,160,000 barrels; yearly production is 360,000 barrels.

By Example (F):

| | A | B | C | D | E | F |
|---------|--|-----------------------------------|---|-----------------|---------------|---|
| | Original Cost less Salvage and previous Deprecia- tion | Amount of Deprecia- tion | Production per year in Barrels | Oil Reserves | Rate (A÷D) | Single Well Cost less Salvage and prior Deprecia- tion |
| 1st yr. | \$54,000 | \$9,000 | 360,000 | 2,160,000 | 2.5¢ | \$9,000 |
| 2nd " | 45,000 | 9,000 | 360,000 | 1,800,000 | " | 7,500 |
| 3rd " | 36,000 | 9,000 | 360,000 | 1,440,000 | " | 6,000 |
| 4th " | 27,000 | 9,000 | 360,000 | 1,080,000 | " | 4,500 |
| 5th " | 18,000 | 9,000 | 360,000 | 720,000 | " | 3,000 |
| 6th " | 9,000 | 9,000 | 360,000 | 360,000 | " | 1,500 |
| Total | \$54,000 | | 2,160,000 | | | |

NOTE: The rate in this instance is a constant because in each year, remaining capital cost is proportioned to oil reserve, both having diminished proportionately

Assume that at midnight December 31st of the 3rd year, three wells went to water and were abandoned and written off. The amount would be \$13,500.00 ($3 \times \$4,500.00$). There would remain a balance of capital cost of the same amount. If the oil reserves of the lease remained the same, we would recompute the adjusted account to obtain a new rate. (This procedure is necessary each year, in any event.)

By Example (G):

| | A | B | C | D | E | F |
|---------|--|-----------------------------------|---|-----------------|---------------|---|
| | Original Cost less Salvage and previous Deprecia- tion | Amount of Deprecia- tion | Production per year in Barrels | Oil Reserves | Rate (A÷D) | Single Well Cost less Salvage and prior Deprecia- tion |
| 4th yr. | \$13,500 | \$4,500 | 360,000 | 1,080,000 | 1.25¢ | \$4,500 |
| 5th " | 9,000 | 4,500 | 360,000 | 720,000 | 1.25 | 3,000 |
| 6th " | 4,500 | 4,500 | 360,000 | 360,000 | 1.25 | 1,500 |
| | \$13,500 | | 1,080,000 | | | |

There has been written off for depreciation \$40,500.00 and for abandonments \$13,500.00 and a total of \$54,000.00 the proper amount ($3 \times \$9,000.00 + 3 \times \$4,500.00$). If, on said abandonment, the oil reserves were cut in half or adjusted up or down, it would make not the slightest difference in the dollar depreciation, only the rate would be affected. Assume reserves are cut in half, the rate is doubled but the annual depreciation is the same; thus

By Example (H):

| | A | B | C | D | E | F |
|---------|--|-----------------------------------|---|-----------------|---------------|---|
| | Original Cost less Salvage and previous Deprecia- tion | Amount of Deprecia- tion | Production per year in Barrels | Oil Reserves | Rate (A÷D) | Single Well Cost less Salvage and prior Deprecia- tion |
| 4th yr. | \$13,500 | \$4,500 | 180,000 | 540,000 | 2.5¢ | \$4,500 |
| 5th " | 9,000 | 4,500 | 180,000 | 360,000 | " | 3,000 |
| 6th " | 4,500 | 4,500 | 180,000 | 180,000 | " | 1,500 |
| | \$13,500 | | 540,000 | | | |

Where a "normal" life asset is expired, it must be written off or else the base could never be reduced; likewise if retired before its normal life it must be written off *then* and not when its anticipated life span is terminated. After the life of an asset is passed, there is that much less in asset value to depreciate. This reasoning applies even to composite rates on varying lives of physical assets.

Here, exactly as in the *Pipeline* case, none of the assets could have a "useful economic life longer than" the *n* years necessary to recover the oil. The conclusion:

"Thus the depreciation there (in the *Pipeline* case) and the deductions being calculated upon the maximum eco-

economic life of the entire plant, not the average life of separate assets, the loss deduction was proper." (*Alcohol* case, p. 1378.)

It is evident that where asset depreciation is based on economic life of some use which itself will terminate without respect to the varying physical life of such asset, that there can never be a double return of the value and there does not exist a plausible reason for the denial of loss due to abandonments.

If we assume 10 articles as a unit each of the value of \$10,000.00 with a 20 year economic life with a straight line depreciation rate of 5% we will have the situation of the *Pipeline* case. No table is necessary to illustrate a simple deduction of \$5,000.00 per year. If four articles are retired and abandoned how is the computation made:

An Example (I):

| | | Amt. of Deprecia- tion | Abandon- ment | Deprecia- tion | Loss by Abandon- ment | Total Cost |
|------------------|-----------|------------------------------|------------------|-------------------|-----------------------------|---------------|
| 1 yr. | \$100,000 | \$5,000 | A-Article | \$ 500 + | \$9,500 | \$10,000 |
| 2 " | 90,000 | 4,500 | B-Article | 1,000 + | 9,000 | 10,000 |
| 3 " | 80,000 | 4,000 | | | | |
| 4 " | 80,000 | 4,000 | C-Article | 2,000 + | 8,000 | 10,000 |
| 5 " | 70,000 | 3,500 | | | | |
| 6 " | 70,000 | 3,500 | D-Article | 3,000 + | 7,000 | 10,000 |
| 7 " | 60,000 | 3,000 | | | | |
| 8th to 20th yrs. | 780,000 | 39,000 | | | | |
| Dep. | | 66,500 | | | 33,500 | |
| Abandonments | | 33,500 | | | | |
| Total | | 100,000 | | | | |

As in the 5 article example (*Alcohol* case) the cost base is reduced not by cost of the article less depreciation but

by the *entire* cost including that portion already depreciated. An article lasted one and should have lasted twenty years, 5% of its life was allowed for depreciation for one year of use, 95% of its expected life failed to materialize; we deduct the actual loss of \$9,500.00 but we must decrease the base by its original cost because no part thereof can be thereafter the basis of further depreciation; if only \$9,500.00 is deducted from the base then the \$500.00 would remain therein and thereby be depreciated over the 19 remaining years and increase the total sum returned through depreciation by \$500.00.

Taking the same data as in the Example "F" we change the depreciation rate to a flat $16\frac{2}{3}\%$ upon the assumption that the life of the oil on the particular lease is six years thereby bringing it in principle within the facts in the *Pipeline* case (there it was 20 years at a 5% straight line rate).

By Example (J):

| | Cost Less Salvage | Depreciation | | Oil Production Barrels | Single Well Cost Less Salvage and Prior Deprecia- tion | Oil Reserves |
|----------|----------------------|---------------------|---------|------------------------------|--|-----------------|
| | | Rate | Amount | | | |
| 1st year | \$54,000 | x $16\frac{2}{3}\%$ | \$9,000 | 360,000 | \$9,000 | 2,160,000 |
| 2nd " | 54,000 | x $16\frac{2}{3}\%$ | 9,000 | 360,000 | 7,500 | 1,800,000 |
| 3rd " | 54,000 | x $16\frac{2}{3}\%$ | 9,000 | 360,000 | 6,000 | 1,440,000 |
| 4th " | 54,000 | x $16\frac{2}{3}\%$ | 9,000 | 360,000 | 4,500 | 1,080,000 |
| 5th " | 54,000 | x $16\frac{2}{3}\%$ | 9,000 | 360,000 | 3,000 | 720,000 |
| 6th " | 54,000 | x $16\frac{2}{3}\%$ | 9,000 | 360,000 | 1,500 | 360,000 |

We again assume that at midnight December 31st of the 3rd year 3 wells went to water, were abandoned and written off. The amount of the deductible loss would be

\$13,500.00 (3 x \$4,500.00). Now there is a change due to the circumstance that in the instant case there has been a constantly diminishing base, whereas in the *Pipeline* case there has been a constant base: both, however, result in the same amount of yearly depreciation. We now reduce the *base* by the entire original cost of the 3 abandoned wells to obtain the new base upon which to compute the remaining amount of the depreciation necessary to recapture the balance of the cost. Oil reserves remain the same.

By Example (K):

| | Cost Less Salvage | | Depreciation | | Oil Production Barrels | Single Well Cost Less Salvage and Prior Deprecia- tion | Oil Reserves |
|----------|----------------------|---|--------------------|---------|------------------------------|--|-----------------|
| | | | Rate | Amount | | | |
| 4th year | \$27,000 | x | 16 $\frac{2}{3}$ % | \$4,500 | 360,000 | \$4,500 | 1,080,000 |
| 5th “ | 27,000 | x | 16 $\frac{2}{3}$ % | 4,500 | 360,000 | 3,000 | 720,000 |
| 6th “ | 27,000 | x | 16 $\frac{2}{3}$ % | 4,500 | 360,000 | 1,500 | 360,000 |

And, as in the same example, used with reference to the Petitioner's case it would not make the slightest difference whether the oil reserves were adjusted up or down because here the depreciation amount is obtained by multiplying the diminished cost by the same flat rate of 16 $\frac{2}{3}$ %.

A much stronger showing is here made for the application of the principle which is the basis of the decision in the *Pipeline* case and which was unequivocally approved in the *Alcohol* case, the distinction resting in “varying physical life” and “economic life”. In the *Pipeline* case it was originally estimated that the two fields would each last twenty years; that's a round amount and clearly a guess which requires the kindest of consideration to call an estimate of their economic lives; the flat

rate of 5% based on a 20 year expectancy might easily be wrong either way, up or down. In any event some of the equipment did not last that long; whether it lasted its "normal" life no one can say and it is an immaterial and false factor to consider in an economic life case. That equipment abandonment loss was allowed even though the Commissioner asserted it was part of an average. Clearly it wasn't. Here, we use through the years an estimate of future oil reserves corrected from year to year as experience (trial and error) shows it to be too high or low and corrected finally to the actual barrels of oil produced. So that each barrel of oil produced is charged with the precise moiety of the value of the physical life actually required to produce it; when six wells were producing, the cost of well equipment of the entire six wells was the base of the rate; after 3 wells were abandoned all the remaining oil was produced solely by using the remaining three wells and certainly only those three wells can be chargeable either physically or in economic usefulness with depreciation based on the value of equipment to produce the remaining oil.

A sum of money is invested in six wells on one oil lease for the economic purpose of producing an estimated amount of oil (oil reserves). If the same sum of money is capitalized it does not make any difference, in fixing the *rate*, whether there are three or six wells. Respecting the capital account, the sole question is the amount of money in that account. That sum of money is one of two factors which go to make up the rate. The other factor is the amount of oil remaining in the ground which in the future will be obtainable. Each year both of these

factors are reduced. The capital account is reduced by that sum of money representing prior depreciation which has already been charged to the account. The balance is a new factor for the year to be computed. Oil being a fixed supply, and a diminishing asset, the amount of oil reserves has been lessened by the amount produced in the prior years. That balance of oil reserves is, likewise, a new factor. So, the new balance of the capital account is divided by the newly computed oil reserves and a new rate is produced, unless, by coincidence, both the capital account and the oil reserve account decreased precisely in proportion, then the new rate would be the same for both years. In making these computations no reference is made nor consideration given to the varying physical life of wells, equipment, or oil wells, or the economic life, except to measure oil reserves against that part of the capital account remaining un-depreciated. The rate being a constant figure for that one accounting period, it is applied to all the producing wells in the *precisely* proportioned production, and, naturally, relatively as well, because the production of oil on the lease is multiplied by the rate to determine the depreciation write-off. The production of each well separately set up in the records is aggregated to obtain this fact. Assume that at midnight on December 31st, a well "goes to water" and is permanently abandoned. We have a capital account which contains this abandoned well, that is, its cost, less salvage, less prior depreciation. The balance is a dead flat loss to its owner. What reason exists to deny the deduction? Has it served to bring down to an average the "well equipment" on the remaining and still producing wells? And, referring to the five-year example

in the *Alcohol* case, has this one year economic life served to bring the five year, on the average theory, to three years? Or the two-year article and four, to the composite of three years? Not at all. And, in an arithmetical sense, it is naive to claim it. The answer seems as certain as the most certain of all sciences gives to all such questions.

Suppose the well never produced: then, its value would never have been capitalized. And if the engineers computed the same reserves all would be produced from the other "well equipments", and the capital account would be less; therefore, the rate would be *less* because a lesser investment would be *used* to obtain the same amount of oil. And, if the oil reserve decreased pro-tanto to the number of wells remaining, the rate would be the same as if the abandoned well had itself been a producer. It is perfectly obvious that the abandoned well has fully served *its* economic usefulness; its life span has terminated *with* its oil supply. It has during its productive life *paid* its way. Its cost is separately set up in the books. That separate cost is not commingled with the cost of any other well of the lease. After a salvage allowance, its net cost is written down each year at an amount per barrel, which is exactly the same amount per barrel that all the other wells on the same lease produced. The cost of each well is different, and the production of the wells varies.

But these differences were not the base of the depreciation. One well cost \$10,000.00 (after salvage allowance) and produced 500,000 barrels of oil; if the rate is one cent a barrel, abandonment brings a loss to its owner of \$5,000.00. Another well on the lease cost \$20,000.00, and produced 10,000 barrels, the rate being the same. The

residual balance of \$19,900.00 remains. All that balance will be eventually written off, exactly, to the last dollar, no more, no less. It does not make the slightest difference how much oil remains to be produced,—100 or 100,000 barrels—whether it captures the oil that the abandoned well might have produced or whether it fails to capture a barrel of it. The rate determines not only the amount of the return by depreciation, but the time element in recouping depreciation losses. This is because a rate is an annual percentage, a ratio of a *balance* of the capital account for that well to an estimated amount of oil remaining.

An estimate of the amount of oil remaining pertains to the beginning of the tax year, and the rate for that year is determined at the end of the year; that is, the *estimate* includes the amount produced during the year because the depreciation rate must, from first to last, exactly pay the capitalized cost. The rate per barrel depends on the number of barrels actually produced. In the last year of production the estimate at the beginning of the tax year is merely corrected to actual production when the wells, or well, is exhausted. Thus, we find that where deductions for abandonment are allowed, each well has paid exactly the amount of its capitalized cost, and in each accounting period each barrel of oil has had the same rate, the amount of the depreciation depending solely on its economic usefulness as measured by the barrel of oil. The only reason of the rule in the regulation is to prevent recoupment by the taxpayer for depreciation and then a double deduction, in whole or in part, by an abandonment, as clearly pointed out in the five-article example where

the one year having served to bring the five year article to the average of three; it could not be written off for abandonment at the end of its normal life because an average contemplates that depreciation will be taken after the average life, to-wit, in the fourth and fifth years. But even there the base of the capital account is decreased each year by the exact amount of the \$10 value; but the recoupment of that \$10 is in and a part of the depreciation returned for the year.

If depreciation represents the diminished value for decretion, an expiration of part of an estimated life, physically in the one instance, and an expiration of a part of its economic usefulness, measured functionally against a diminishing resource in the other, which conception is purely an empirical one and an expedient, how much more proper is it that allowance be made when the whole is gone, when actual physical life has terminated or its functional life expired, unless the method results in a double return by use of a formula which has already offset a short existence of one article against a long existence of another to establish a mean or average, or composite, exactly half-way between the two, a wholly non-existent circumstance here. How, then, may the estimate of a part of a value, the empirical, be allowed, and when the entire value, actual and not an estimate is certainly lost, that loss be denied?

As pointed out by the Board in the *Pipeline* case:

“The statute allows a taxpayer deductions for losses upon retirement of assets. It is of course proper to consider the method of computing depreciation and to see that double deductions do not result. There is

in the present case no distortion of income resulting from double deductions in this connection. On the contrary, if the retirement losses are disallowed, the deduction for depreciation would have to be increased in order to reflect income correctly'' (p. 1081.)

Assume an oil lease with ten producing wells each having a tangible asset cost of \$20,000.00 capitalized on the books of the owner. Then assume a unit production method of depreciation is used based on its hypothetical oil reserves. Obviously, this is grounded on a primary assumption: that the capitalized value of the tangible assets (well equipment) will be *physically* used until all the recoverable oil is exhausted. But its life-years will gradually expire (decretion) so that when the time arrives when the oil is exhausted it has a remaining life measured only by the salvage ratio to cost of ten per cent. (Such salvage proportionate value being universally used and respecting the fairness thereof there has never been any question in the instant or in any other case.) This salvage rate is grounded upon the fact that a large proportion of "well equipment" is lost when the well is abandoned, to-wit, the surface string of pipe, the water string of pipe running from the surface to the oil sands, the liner, the packer, etc. The basis of the entire computation is the *entire investment* of well equipment so capitalized (10 wells x \$20,000.00 each equals \$200,000.00). Now assume 5 wells go suddenly to water and are abandoned. Instead of \$200,000.00 of capital assets being necessary to produce the remaining underground oil only \$100,000.00 is left. The \$100,000.00 must be written off irrespective of any question affecting income tax. Otherwise income is dis-

torted. It would be clearly a fraud on the part of a corporation against its stockholders to carry on its book non-existent assets and to falsify income for the year. So, the proper accounting procedure is to deduct from the cost (capitalized value) the amount of depreciation, if any, theretofore taken, further deduct the salvage value, and write off the balance.

The regulation itself provides that a deduction of an abandonment or retirement loss is allowable where the depreciation is based upon the expected life of the longest lived asset in the group.

“In the case of classified accounts, if it be the consistent practice of the taxpayer to base the *rate* of depreciation on the expected life of the longest lived asset contained in the account * * * a deduction * * * less its salvage value, is allowable upon its retirement.”

Average of terms, periods or lives, is the mean, a middle point between the high and low. Obviously, it is longer than that of the shortest lived unit of a group but shorter than the longest lived unit. It follows that where an average life is used, the capital account becomes fully depreciated before the final item included therein has been fully worn out and discarded. In the example used above, the entire capital account is exhausted in three years although Article “‘D’-4 year”, and “‘E’-5 year” have 1 and 2 years of life remaining. But under the “unit of production” method used by Petitioner, it is certain that the full capital investment could not be recovered until the last drop of oil is recovered. Instead of providing for a full recovery before the end of the life of the longest lived unit (as an average must necessarily allow, it being

an average and somewhere below the highest and above the lowest) as is *always* the case under average or composite life method, the procedure followed by Mohawk *did not permit the full recovery of cost until the end of the life of the longest lived unit (depreciable article) of the group*. Consequently, under the regulations there must be an allowable deduction for retirements, discards and abandonments. Either the quoted paragraph means precisely that which it directly and unequivocally states or it is meaningless, nullified by construction in denying a right created thereunder.

And, in any event, Petitioner's contention respecting this construction of the paragraph is identical with the construction placed thereon by the Board in the *Pipeline* and *Alcohol Company* cases, *supra*, and the District Court of the United States in the *Brick* case, *infra*.

L. THE BRICK CASE.

Mason City Brick and Tile Co. (D.C.), 36 Fed. Supp. 515-520.

A composite rate of depreciation was the basis of the computation on numerous items of equipment used in fabricating clay products. The Commissioner refused to allow loss deductions due to an abandonment because a composite depreciation rate was used and, therefore, the taxpayer should be left to realize recoupment over future years. The Court held:

“In this case, however, the amount of the loss was removed from the depreciation basis (same as in the instant case) so that the aggregate depreciation in future years would not include the diminution of

value through abandonment. * * * Any credit necessary to be made to the depreciation account to prevent double benefits to the taxpayer, if any, should be applied to years subsequent to 1936 and 1937. * * * I conclude the plaintiff's contention is the correct one and that plaintiff should be entitled to the reduction and consequently to recover the excess of tax exacted in accordance with law and the government's custom of payment in such cases."

M. THE WITHERSPOON CASE.

Witherspoon Oil Company, 34 B. T. A. 1130.

There, two questions were raised: Whether (1) undepleted cost of capitalized cost of intangible development (a question not here involved) and (2) undepreciated cost of capitalized physical equipment might be deducted upon abandonment of one or more wells on a given lease where other producing wells remained.

The Board held (1) that undepleted development cost was not deductible, but (2) that the undepreciated cost of the physical assets abandoned were deductible.

"In so far as the amounts here claimed represent undepreciated costs of physical assets * * * the petitioner is entitled to deductions upon abandonment of the wells to which they relate * * *" (p. 1137.)

The findings of fact (p. 1133) were:

"Petitioner did not keep separate depletion and depreciation accounts for each well. Such charges, when made, were in a lump sum for the entire Burke tract. As entries for depreciation and depletion were made as to each well a computation became necessary. The amounts used by the petitioner as depletion and de-

preciation in determining the loss on the abandonment of these wells was computed in the following manner:

The amount of depletion to be deducted for any given taxable year with respect to the lease as a whole was determined by dividing the amount of oil produced for that year into the amount of the reserve of estimated recoverable contents, thus obtaining the unit of depletion. The cost or other basis of the property was divided by the unit of depletion thus obtained to arrive at the amount of deductible depletion. The amount of depletion was then apportioned among each of the wells on the basis of the number of months that each well was producing. The amount of depletion allocable to a well down to the time of abandonment was used in computing the loss sustained on abandonment. The same method of apportionment was followed with respect to the computation of the depreciation allocable to the physical assets involved."

Also on pages 1131 and 1132 it is stated that:

"The cost, tangible and intangible, of each well drilled was capitalized and carried separately on the petitioner's books. Except for the first well drilled, and then only until the second well was brought in, the petitioner kept no production records of individual wells as the production from all the wells was run into field tanks where a production gauge was made of the oil."

N. THE MISTAKEN ASSUMPTION OF THE BOARD OF TAX APPEALS.

In the deficiency letter no question was raised by the Commissioner except the single issue of whether the regulation (Tr. p. 18) was applicable; no suggestion was made

that the abandonment of the well equipment had not occurred or that the useful life of said equipment was not thereupon lost to the Petitioner, nor that due allowance had not been made for salvage. In the presentation to the Board, counsel for the Commissioner raised no such questions; it was assumed by both litigants that the only question was the construction of the regulation.

If the decision of this Honorable Court is in favor of the construction of that regulation as urged by Petitioner, it would be most unfortunate if the case is decided upon an erroneous inference of fact drawn by the Board in its opinion. The Board declared:

“On the other hand, equipment in some wells may still have considerable useful life after a well becomes non-productive. The fact that a well becomes non-productive and is abandoned does not necessarily result in the complete loss of usefulness of the equipment thereon or accelerate its depreciation or constitute abnormal retirement of the equipment. Such equipment may be, and often is, used at other wells. The stipulation shows that the wells involved were abandoned, but there is no evidence showing that the equipment thereon was also abandoned because it had lost its usefulness or that the abandonment of the wells caused depreciation of the equipment in excess of that normally sustained. * * * There is no evidence that the equipment was actually retired or abandoned because it had lost its economic usefulness and had no more than scrap or salvage value or no value. * * * The life of the well does not determine the life of the equipment. There is no evidence that the equipment had outlived its usefulness or that the retirement of the equipment was necessitated by unusual or abnormal circumstances.”

When the term "oil well" is used, it has a definite, fixed meaning to all persons who are familiar therewith. It would be a mistake to assume that it consists of a hole in the ground only. A producing oil well is a integrated, composite, physical thing. First, a derrick is erected, in this instance wooden. In erecting the derrick, underneath the floor thereof there is a concrete foundation and the entire area is cemented. And in the center thereof is a cellar, or basement, concreted so that work can be done in connection with pipes underneath the derrick floor. When a well is "spudded" in and drilled, it is the usual practice to put into the well a surface string which, in the wells in question, run anywhere from 500-1000 feet, dependent upon where, in these upper strata, are pebbles or rocks. This is a mere structural entity, having no reference or no use when the well is completed. Its purpose is to facilitate drilling of the well and to prevent the upper formations caving in and pouring down on the drilling tools as the well is being drilled. When the oil sands are reached, it is necessary to set a string of pipe all the way to the surface. This is called the water string. The bottom sets in that impervious stratum immediately above the oil sands. Its purpose is to prevent the infiltration of upper waters into the oil horizon. When it is initially set, special cement is pumped in under great pressure so that the cement will go behind the pipe, between it and the surrounding earth, to constitute a solid block and to prevent water coming down between the pipe and the earth. When the oil sands are drilled out, a liner is placed in the well which runs to the bottom and the top of it is somewhere within the water string. This pipe is perforated so that the oil flows into the liner and usually

has sufficient pressure so that the oil runs up into the casing on a pumping well. And on a flowing well, the pressure is sufficient to build up a continuous stream from the liner to the surface—and hence cause the flow.

The life of an oil well is coexistent with the amount of oil which the well ultimately produces, both in a functional-use sense and as to the time or duration of its existence. The well is permanently abandoned because the owners know it will not produce oil at a profit, the most usual cause being infiltration of edge water. The well, all of it, has come to the end of its life. Eliminating salvage value, both the physical and functional life has ended. By abandonment is not meant that it remains merely idle and non-productive. It is destroyed forever. The word “abandonment”, in a generic sense, has a well-defined meaning: it is a permanent surrender, both in intent and act. But in relation to an oil well, it has a specific meaning. Under the laws of the State of California the producer is required to abandon oil wells under the supervision of the State Oil and Gas Supervisor. Specific reference to these statutes are set forth in Error No. 11. (Tr. p. 100.) The purpose of such supervised abandonment is two-fold:

(a) to protect the oil sands from infiltration of upper water (as distinguished from edge water in the same stratum); and

(b) to protect upper waters both for irrigation and domestic use from contamination by oil and gas.

The only means by which this is accomplished is to require that the water string remain in the well when it is abandoned. Even without such legal requirement it is rarely

possible to pull any part of the well casing where subject to lateral pressure of the earth; the only part capable of recovery, were it not for the inhibition of law, is that part of the water string which is within the surface string, and, hence, not at the point in contact with the earth.

The decision of the Board, therefore, went off on a mistaken assumption respecting facts wholly non-existent. It needs no extended argument to support the axiom that cases ought to be decided on actual and truthful facts, particularly where the facts are readily available, within the knowledge of both parties, and there is a procedural method by means of which the correct facts can be made of record and available to those Courts and Boards vested with authority to decide issues of law based thereon. And there can be no possible question that the Petitioner here could not reasonably anticipate the Board's decision in this respect and was misled by the circumstance that the Commissioner raised but one issue and made no suggestion that the physical equipment had not been abandoned or wholly lost, or that the entries respecting same on Petitioner's books were not truthful. In what appears to be a uniform line of decision, the Courts have held, particularly in tax cases, that if the Circuit Court of Appeals cannot make a final decision because of the absence of certain facts then the principle (the rule of decision) ought to be declared by it and the case remanded to the Board to take further testimony and to decide the case within the rule.

Wyoming Investment Co. v. Commissioner, 70 Fed. (2d) 191;

Eau Claire etc. Co. v. Commissioner, 65 Fed. (2d) 125;

Commissioner v. Wright, 47 Fed. (2d) 871;
Newell v. Commissioner, 66 Fed. (2d) 102;
Underwood v. Commissioner, 56 Fed. (2d) 67.

Here it was stipulated that the "wells equipment" was abandoned and that the salvage write-off was ten percent of cost. (Tr. pp. 49-58.) Under a fair and reasonable construction of the stipulation the Commissioner would be estopped to deny the facts. And, this estoppel runs against the Board of Tax Appeals.

"Abandonment consists of an actual act of relinquishment accompanied with the intent and purpose primarily to give up a claim and right of property."

Justice v. Burgess, 52 S. W. (2d) 720.

RECOUPMENT.

The Petitioner has concededly overpaid its income and excess profits tax for the year 1938 by the sum of \$5660.87; the Commissioner notified Petitioner by letter dated October 4, 1940 that if a claim of refund were made the same would be paid. It is, therefore, conceded that respondent owes Petitioner that sum, plus interest. The statute of limitations has run against any claim of refund which Petitioner might now file. The sum involved in the overpayment was solely occasioned by, and is the result of the ruling of the Commissioner disallowing the loss for abandonment claimed under the main issue here raised for the two years, 1936 and 1937. Because of that disallowance the base, that is the capitalized "wells

equipment'' was increased by the amount of items which Petitioner had previously written off (1936: \$5055.13; 1937: \$35,026.52) resulting in a tax for the succeeding year of \$5660.87. While the Commissioner did notify Petitioner that such claim of refund would be allowed if filed, yet Petitioner could not make such claim without admitting that the Commissioner's ruling was correct in not permitting the abandonment loss. An estoppel would prevent claiming a refund for a lesser amount while litigating a greater sum for the two previous years. The Petitioner would be entitled to the refund only if the Commissioner's disallowance of the abandonment loss was correct. Then, and now, Petitioner maintains error in that ruling. If, on that main issue, Petitioner has mistaken the law, and the taxes of 1936 and 1937 are increased by the sums claimed in the deficiency notice, *then* Petitioner would, for the first time, be permitted to claim an offset by the amount of the overpayment of 1938 taxes. This petition to review the decisions of the Tax Court of the United States was filed in that Court on January 29, 1943. On the same day the United States Circuit Court of Appeals, Eighth Circuit, rendered its decision in *Gooch Milling and Elevator Company v. Commissioner*, 133 Fed. (2d) 131, holding that the taxpayer there was entitled to an equitable recoupment and offset under facts paralleling those in the instant case; and, further holding (in effect) that it was error on the part of the Board to refuse the right to amend the petition, setting up as an alternative the recoupment defense.

All of the Petitioners pray leave to file an amendment of the petition in this proceeding setting forth the alterna-

tive defense of recoupment; that a copy of said proposed amendment is set forth in an appendix to this brief. While we urge this procedure of amendment as convenient and orderly, nevertheless, it is not, under the reasoning of the quoted case, necessary in view of the circumstance that full proof of the over-assessment appears of record. The proof of the claim and the amount determined is in the record (although the issue is not raised in either the original petition to the Board or in this petition to review the order and decision of the Board). Quoting the deficiency notice of October 4, 1940:

“You are advised that the determination of your income tax liability * * * discloses an over-assessment of \$5,660.87 for the taxable year 1938. * * *” (Tr. p. 14.)

And in the “Statement” of account (Tr. p. 15) is shown under the caption “Overassessment” the sum of \$5660.87, and the letter declares that a certificate of overassessment will issue in due course and that to prevent the operation of the statute of limitations a claim for refund should be filed. (Tr. p. 16.) The detailed computation of adjustments to net income for 1938, the explanation thereof and the computation of the tax are set forth. (Tr. pp. 26 to 31.)

Quoting from the *Gooch* opinion:

“This court has power to affirm, or if the decision of the Board is not in accordance with law, to modify or reverse the decision with or without remanding the case for a rehearing ‘as justice may require’. This we did in *Helvering v. Hormel*, 8th Cir. 111 F. (2d) 1, and the Supreme Court affirmed *Hormel v. Helvering*, 321 U. S. 552. In the *Hormel* case the

Supreme Court said, 'there may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider the questions of law which were neither pressed nor passed upon by the court or administrative agency below'.

"In the instant case the doctrine of recoupment was pressed upon the Board. But if we have the right to consider the question if it had not been so presented to or passed upon by the Board, the fact that it was so presented, cannot deprive this court of the power to apply it here 'as justice may require'. The order appealed from is, therefore, reversed and the cause remanded to The Tax Court of the United States as successor to the Board of Tax Appeals for further proceedings consistent herewith."

On the merits of recoupment the opinion quotes with approval the statement in an earlier decision, *Crossett Lumber Co. v. U. S.*, 8th Cir., 87 Fed. (2d) 930:

"The basis of the doctrine is that principle of natural justice which denounces a claim as unjust, immoral and fraudulent when the claimant is at the same time wrongfully withholding money which in equity belongs to the other party."

If the decision of the Court in the *Gooch* case is correct, there can be no serious question that if the main issue should go against Petitioner, in any event, it is entitled to an offset in the sum of \$5660.87 plus interest.

Petitioners respectfully pray:

- (a) That the decision and order be set aside; or
- (b) To remand the cause to the Board of Tax Appeals to take testimony on the issue of whether there was an

actual physical abandonment of wells equipment to the loss of Petitioners and the value of salvage, if any; or

(c) To adjudge an equitable offset.

Dated, San Francisco,

April 7, 1943.

JACOB H. SAPIRO,

EDWIN V. McKENZIE,

Attorneys for all Petitioners.

(Appendix Follows.)

Appendix.

Appendix

Proposed Amendment to the "Petition for Review and Assignments of Error".

By adding to Paragraph III (Tr. p. 98) thereof, the following:

III.

That the respondent adjusted the net income of Petitioner, Mohawk Petroleum Company, for the tax years 1936-1937 and 1938 by disallowing losses due to the abandonment of four oil wells hereinabove referred to; that the adjustment of the said net income for these three years was due to a single ruling that the said losses be added back to the capitalized "wells equipment" and computing depreciation for the year 1938 on said account so adjusted; that the income and excess profits taxes so computed reflected an overpayment of taxes by said Petitioner in the sum of \$5,660.87 for the year 1938.

By adding to Paragraph IV (Tr. p. 101) under the caption "Assignments of Error", the following:

(13) In the failure to allow as a deduction from Mohawk Petroleum Company's tax liability for the years 1936 and 1937 an overassessment and overpayment by said company in the sum of \$5660.87 for 1938 as an equitable recoupment and offset.

By adding to the prayer of the Petition, the following:

That in the event that this Honorable Court shall decide in favor of respondent and against Petitioners, adjudging a tax liability for the years 1936 and 1937, that the Petitioners be allowed an offset for the overpayment of \$5660.87 for the tax year 1938.

Respectfully submitted,

Jacob H. Sapiro,

Edwin V. McKenzie,

Attorneys for all of said Petitioners.

(To be verified.)

